Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:TL-N-1948-01

date: April 2, 2001

to: Thomas McDonell
LMSB Team Coordinator

from: Roy Wulf, Attorney
Seattle District Counsel

subject: [redacted]
Security Agreement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memorandum responds to Larry Nakata's request for assistance dated September 12, 2000. This memorandum should not be cited as precedent. [redacted] requested a refund pursuant to the modified expedite refund procedures. You requested our assistance in determining whether the [redacted]'s ("[redacted]") proposed security agreement is sufficient to meet the requirements of IRM 457(10).5.

I. BACKGROUND

[redacted] filed a claim for refund on form 1120X for the tax years ended June 30, [redacted], June 30, [redacted], and June 30, [redacted]. The refund is partially based on foreign tax credit carrybacks released for the year ended June 30, [redacted], as well as a FSC transaction-by-transaction claim for the taxable years ended June 30, [redacted] and June 30, [redacted]. [redacted] also filed amended returns for its FSC for the years ended June 30, [redacted] and June 30, [redacted]. See Larry Nakata's memorandum to District Counsel dated September 12, 2000. You computed the net tax refund due to [redacted] as

$[redacted], plus interest and restricted interest. See your memorandum to "Joint Committee and Counsel Reviewers" dated July 31, 2000.

You indicated that the examination of the tax years ended June 30, [redacted], and June 30, [redacted] (which has not yet commenced) will not be completed for about two years. You also stated that in addition to the amounts in the claim, [redacted] has "[redacted]" of dollars in additional carrybacks from the year ended June 30, [redacted] available to it. Therefore, you asserted, there is no real likelihood that [redacted] will be required to return the amount of the requested refund. Moreover, you indicated that [redacted] will increase the security from $[redacted] to $[redacted].

[redacted] decided that rather than posting a bond or providing a letter of credit as security for the refund, it would place a FNMA bond in escrow. [redacted] indicated that the reason for this approach is that it saves them [redacted] dollars. A copy of [redacted]'s first draft of a security agreement was attached to Larry Nakata's September 12, 2000 memorandum.

[redacted] did not make a refund claim under section 6411 (the tentative refund provisions), probably because this matter involves the carryback of foreign tax credits.

II. COUNSEL'S INVOLVEMENT

Last fall, the parties decided to delay any substantive discussion of the draft security agreement until the transfer pricing issues had been resolved. However, in [redacted], while we were meeting to discuss the transfer pricing issues, I told [redacted] that the draft security agreement did not bind the escrow agent and was not enforceable, and was therefore inadequate. On [redacted], [redacted] ([redacted]'s outside counsel) called me to discuss the agreement and I explained my concerns. The following day, he informed me that his firm would revise the agreement, coordinate with [redacted] and forward the revision to me.

On [redacted], [redacted] faxed me a revised security agreement. I noted a number of typographical errors and other problems, and discussed them with you. You agreed to my proposed changes and asked me to discuss them with [redacted] and its attorneys. On [redacted], [redacted] (of the [redacted] in-house [redacted] staff), [redacted] and [redacted] ([redacted]'s partner) called me, and I described my concerns. I received [redacted] revised document on [redacted]. He did not change Attachment A, but addressed all of the other issues I had raised in our telephone conversation.[1]

On March 27, 2001, [redacted] and [redacted] (also of the [redacted] in-house [redacted] staff) called me. I told them that I had noted two additional small changes, both on page 2 of the draft agreement. In the third full paragraph, "net refunds" should be "Net Refund", and in the fourth full paragraph, "stated principal value" should be "stated principal amount." The [redacted] attorneys agreed to these changes, which were for purposes of consistency within the document, and were not substantive.

In a telephone conversation earlier today, you and I discussed the fact that the proposed security agreement terminates upon the conclusion of the audit of the [redacted] tax year, while certain the claim is based on carrybacks from the [redacted] tax year. You stated that you expect [redacted] to agree to a later termination date.

III. EXPEDITED REFUND

A. General Rules

The Service has determined that [redacted] overpaid its income tax for the years listed in its claim for refund. It may refund the amount of such overpayments. I.R.C. § 6402(a); Treas. Reg. § 301.6402-1. The general procedures for making a claim for refund of income tax are found in Treas. Reg. sections 301.6402-2 and 3. Because the anticipated refund exceeds $2 million, the Service must first comply with section 6405(a), which prohibits the refund of income tax in excess of $2 million until after a report is submitted to the Joint Committee on Taxation.

The Joint Committee Handbook (Rev. 4/30/99)(IRM 4.3.5) provides the Service's current procedures for submitting proposed refunds for approval by the Joint Committee in implementation of section 6405(a). The Handbook has not been revised to reflect the Community Renewal Tax Relief Act of 2000, which increased the dollar requirement from $1 million to $2 million for reports after December 21, 2000.

A "modified expedite refund report" must be used when obtaining Joint Committee approval for an "expedited refund" without waiting for the completion of a survey or examination.

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[1]The problem with Attachment A is that it gives the escrow agent a security interest in the bond, so that the escrow agent can collect its fees from the bond. However, the annual fee is $10,000, which is not material, especially once you negotiated a $[redacted] increase in the amount of the security.

IRM 4.3.5.5.4; IRM 4.3.5.6.5. This report may be used when there are "unagreed issues" or "unexamined source years." IRM 4.3.5.5.4. In Field Service Advice 200101019 and Field Service Advice 200037039, these provisions were explained as follows:

> Cases involving unagreed issues are those in which the taxpayer and the Service are prepared to make a partial agreement for the assessment or abatement of some tax liabilities without resolving all of the pending issues for a tax period. Cases involving unexamined source years are those in which the Service and the taxpayer have resolved the issues for the tax year with the exception of carrybacks or carryforwards from other "source years" that are still being examined.

However, this definition is not exclusive. For example, in Field Service Advice 200101019, the source year was unexamined, and there was no carryback to an examined year. Clearly, the most important consideration is that the Service is able to determine that there was an overpayment, as required by section 6402. Section 6402 does not require a final determination that there is an overpayment; otherwise a refund could never be authorized until there were no unexamined source years. Moreover, if a refund could not be issued until there was a final determination of an overpayment, there would be no need to obtain security. The Service must have some discretion.

B. Procedures for Modified Expedited Report

Chapter 6 of the Joint Committee Handbook contains the procedures for using the modified expedited report, and requires that the following conditions to be met before the report can be prepared and sent to the Joint Committee:

A. There must be a claimed section 6405(a) refund amount subject to Joint Committee Review in excess of $1,000,000.00 in an unexamined or unsurveyed source or carryback year, IRM 4.3.5.6.5.1 (presumably, as discussed above, after December 21, 2000, the relevant amount is now $2 million);

B. The examination of the unagreed issues or the source year will require a substantial period of time (six months or more) to resolve, and "the delay would deprive the taxpayer of a timely refund to which the taxpayer is clearly entitled," IRM 4.3.5.6.5.1;

C. The taxpayer must post an acceptable bond or similar security, if required, IRM 4.3.5.6.5.1;

D. The report must contain an explanation of why the refund is being issued before the case is completed or surveyed, including a conclusion that no disadvantage to the government will occur as a result of the early refund, IRM 4.3.5.6.5.2;

E. The refund may reflect only the minimum amount to which the taxpayer is entitled, regardless of the outcome of the unagreed issue, IRM 4.3.5.6.2(1), 4.3.5.6.2.(4), 4.3.5.6.3(1), and 4.3.5.6.3(5);

F. A supplemental report must be submitted at the end of the examination or survey, IRM 4.3.5.6.2(3) and 4.3.5.6.3(4); and

G. The refund may not be one involving tentative refunds. IRM 4.3.5.6.2(1) and 4.3.5.6.3(2).

The November 2000 issue of the Joint Committee Reviewer (Vol. 3 Issue 3)("the Newsletter") contains a special report entitled "Clarification of IRM 4.3.5 Chapter 6" which explains IRM 4.3.5.6.5 as follows:

> This section provides for the reporting to the Joint Committee of refund claims requested by the taxpayer to be paid prior to examination or survey after assignment of the claim issues and/or years. The taxpayer must provide the Service with an irrevocable bank letter of credit or a surety bond prior to payment of the unexamined claim. Taxpayers usually request this procedure because a Form 1139 or 1045 was not timely filed for NOL tentative allowances; or because unused FTC carrybacks cannot be reflected on Forms 1139 or 1045; or because section 1256 capital loss carrybacks cannot be reflected on Form 1045.
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> This type of case is reported to the Joint Committee via a Modified Expedite Refund Report, that specifies that the taxpayer has entered into a binding collateral security agreement and has provided security for the amount of the requested refund plus accruable interest.

C. Application of General Rules to [redacted]

The Manual refers to "unagreed issues" and "unexamined source years." As explained above, the Service may determine that there has been an overpayment without surveying or examining the years in question. Here, the Service has determined that [redacted] is entitled to recover the claimed refund amount, and has a high degree of confidence that the claim will ultimately be allowed. Counsel is not in a position to question this determination.

The proposed security agreement allows [redacted] to close out the escrow if the examination of the [redacted] and [redacted] taxable years and the [redacted] and [redacted] FSC taxable years is fully agreed. See paragraphs 5, 6 and 7 of the proposed security agreement. However, the claims is largely based on foreign tax credits carried back from the tax year ended June 30, [redacted]. The agreement should be revised so that the examination of that year is completed before the escrow can be terminated.

There are a number of ways to accomplish this goal. One method is as follows:

1. Define "[redacted] taxable year" in the second paragraph of the agreement. The wording could be as follows:

> claiming carrybacks of foreign tax credits from the taxable year ended June 30, [redacted] (hereinafter "the [redacted] taxable year"),

2. In paragraph 5 of the agreement, a sentence could be added, stating:

> As soon as practicable after the completion of that examination, the Service shall commence an examination of the [redacted] taxable year.

3. The first sentence of paragraph 6 of the agreement could be revised, to state:

> As a result of the examinations, the Service may determine deficiencies in the tax for the [redacted], [redacted], [redacted] or [redacted] taxable years or the [redacted] or [redacted] FSC taxable years that were not taken into account in calculating the Net Refund.

4. In paragraph 7 of the agreement, the references to "examination" should be changed to "examinations", since the [redacted] taxable year will be examined separately.

An alternative approach would be to include the examination of the [redacted] taxable year with the examination of the [redacted] and [redacted] taxable years (thus requiring a three-year cycle).

D. Security for interest

The Service has the discretion to forego security on related interest. The Manual states:

> At the discretion of the district director, an additional amount of bond or security may be required with respect to interest on the refund in the event all or part of the refund must be repaid. This amount should be measured by the reasonable anticipated time to complete the examination and the interest rate currently in effect under IRC 6621.

IRM 457(10).5(1)(c). The discretionary security is for potential underpayment interest that may be due, pursuant to Section 6601, on the refunded amount if the refunded tax must be repaid to the Service at the end of the audit. The overpayment interest on the amount expeditiously refunded is relevant only in calculating the anticipated underpayment interest.

The purpose of the security is to protect the Service from the taxpayer's nonpayment of the tax if it is subsequently determined that the taxpayer was not entitled to the refund. The security will enable the Service to quickly recover the amount that was refunded by enforcing the security agreement regardless of the taxpayer's financial condition at the end of the audit. In evaluating the need for obtaining security on the interest, the Service can consider any factors that might affect the Service's ability to collect the tax and underpayment interest. Key factors could be:

1) the amount of the refund;

2) the amount of underpayment interest that would have accrued at the time the expedited refund request was made;

3) the anticipated length of the audit and the amount of any additional underpayment interest that would accrue if, at the end of the audit, it was determined that the taxpayer was required to repay tax in the full amount of the refund;

4) the strength of the taxpayer's position and the likelihood that the Joint Committee will approve the refund;

5) the taxpayer's financial condition;

6) the extent of the taxpayer's business within the United States and the amount of the taxpayer's assets within the United States; and

7) any events that might affect the financial well-being of the taxpayer.

In this case, you have estimated the time to completion of the audit cycle as two years, though completion of the examination of the [redacted] tax year will probably be delayed another two years. By increasing the amount of the FNMA bond to $[redacted], [redacted] has provided some cushion for interest. Moreover, [redacted] has a strong position with regard to the underlying claims, an excellent financial position, significant assets and business within the United States and there is no reason to believe that [redacted] will be unable to meet its tax obligations.

E. Use of the escrow agreement

A taxpayer must "post bond or similar security (e.g., a collateral agreement with an irrevocable letter of credit in favor of the district director having jurisdiction over the return)" as a condition for submitting a modified expedited refund report. IRM 4.3.4.6.5.1, 3. The Newsletter contains the following sentence:

> The taxpayer must provide the Service with an irrevocable bank letter of credit or a surety *bond prior to payment of the unexamined* claim.

The above language was written by Joint Committee Coordinator Bernard DeRango, who has since retired. I discussed this phrase with his replacement, Joe Panepinto, and with Vern Stovall (also a Joint Committee Coordinator). They stated that the Newsletter was not meant to limit the type of security, and concluded that a FNMA bond may be adequate security.

I reviewed the security agreement, relying upon Exam's review of the unnumbered paragraphs on pages 1 and 2 of the agreement. The dollar amounts tie to the workpapers attached to your July 31, 2000 memorandum. My review of the numbered paragraphs is based on the following:

Paragraphs 1-2. Basic boilerplate for escrow agreements.

Paragraph 3. I am relying on Exam to confirm that the amounts are correct. The dollar amounts tie to the workpapers attached to your July 31, 2000 memorandum.

Paragraph 4. This paragraph is adapted from the Internal Revenue Service Manual Handbook 4.3.5 ("Handbook"), paragraph 3. The adaptation seems reasonable.

Paragraph 5. This paragraph is almost identical to Handbook paragraph 4.

Paragraph 6. This paragraph is adapted from Handbook, paragraph 5. The adaptation seems reasonable.

Paragraph 7. This paragraph is adapted from Handbook, paragraph 6. The adaptation seems reasonable. It incorporates the language requested by the Joint Committee on Taxation.

Paragraph 8. This paragraph is adapted from Handbook paragraph 7, but is significantly different. The changes are due to the use of the Bond and seem reasonable.

Paragraph 9. This paragraph is almost identical to Handbook paragraph 8.

Paragraph 10. This paragraph is required because an escrow was used. Subparagraph (a) concerns obligations between [redacted] and the escrow agent. Subparagraph (b) incorporates Attachment A. This attachment is primarily concerned with obligations of [redacted] to the escrow agent. The Service's obligations seem reasonable. However, the Attachment provides that the escrow agent has a security interest in the Bond, superior to the Service's rights in the Bond.

Paragraph 11. This paragraph is required because an escrow was used. The notice provisions are reasonable, given the language of the Handbook.

Paragraph 12. This paragraph is required because an escrow was used, and concerns obligations between [redacted] and the escrow agent.

Arlene Blume of our National Office reviewed the security agreement and indicated that she believed it provided adequate security.

F. Authority to execute the agreement

IRM 4.3.5.6.5.3(2) states that "if the taxpayer and the district director enter any type of written security agreement other than the posting of bond," the agreement should be submitted to the Joint Committee. Implicit in this section is the district director's authority to execute a security agreement. Now that the district director position has been eliminated, much of the authority once assigned or delegated to the district director has been delegated to the LMSB directors.

Delegation Order Number 40 (Rev. 6), effective 5/20/1997 and updated 10/2/00 to reflect new organization titles, gives LMSB Directors the following authority:

> After compliance with all requirements of existing procedures for review, to make credits or refunds, within the applicable period of limitations, of overpayments in any amount, of any internal revenue tax, additional amount, addition to the tax, assessable penalty and allowable interest thereon, including those cases requiring a report to the Joint Committee on Taxation.

JoAnn Bank, the Director of Field Operations for Communications, Technology and Media, therefore has the authority to execute the Security Agreement and act as an "Authorized Person" as that term is defined in the Security Agreement. In addition to JoAnn Bank, you may wish to add Tom Wilson, the LMSB Industry Director for Communications, Technology and Media as an Authorized Person.

IV. RECOMMENDATIONS

The draft security agreement attached to this memorandum does not reflect the changes agreed to on [redacted] (see page 2). It also does not reflect the increase in the amount of the security, which can be accomplished either by replacing the bond already in escrow, or adding an additional bond. The agreement must be revised to reflect this change.

More importantly, the draft security agreement does not require that the [redacted] taxable year be examined prior to any termination. The agreement should be revised to do so.

Your submission to the Joint Committee meeting should be written to meet the requirements set forth in the Handbook, as listed above.

Please call me if you have any questions.

By:______________________________
ROY WULF
Attorney